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No. 5

# Supreme Court of the United States

HARRY H. NEUBERGER,

Petitioner,

—*against*—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

## REPLY BRIEF FOR PETITIONER

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October, 1940.

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HARRY H. NEUBERGER,

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*—against—*

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

## REPLY BRIEF FOR PETITIONER

The Government has failed to disprove the existence of the principle that partnership income retains its character on individual partners' returns. We have demonstrated that such principle has controlled the taxation of partnership income in all the Revenue Acts since 1913.

The Government urges the existence of a statutory "scheme" following a pattern established in 1918, said to be inconsistent with such principle (Gov. Br. 5, 10). It cites not a single instance (except the case at bar) in which such "scheme" has been applied to prevent items of partnership income from retaining their character on partners' returns.

This is not the scheme which the Government had in mind in November, 1939, when, in its brief in the *Craik* case, it

felt called upon to apprise the Court of Claims that the rule of the *Coulby* case had been accepted by the Treasury in most instances as the law under subsequent Revenue Acts (Pet. Br. 15).

The fact is that the courts, the Congress, and (in three instances where the statute was silent) the Treasury have all applied the principle for which we contend.

The Government ignores the historical development of this principle. It disregards Mr. Justice Holmes' admonition that in the interpretation of a tax statute "a page of history is worth a volume of logic." *New York Trust Co.* v. *Eisner*, 256 U. S. 345, 349. Finally, its argument is shot through with fallacies.

## I.

## Petitioner's proof of the general principle.

The Government either ignores or concedes the following significant points:

1. The first provision in any Revenue Act (Section 8(e) of the 1916 Act dealing with dividends and Government bond interest), which specifically provided that an item of partnership income retained its character on partners' returns, was inserted to make clear Congress' disapproval of the Treasury's erroneous interpretation of the 1913 Act (Pet. Br. 11-13).

2. The Treasury consistently ruled in a variety of situations over the sixteen year period from 1919 to 1935 that items of partnership income retain their character on partners' returns in the absence of statutory provision (Pet. Br. 14).

3. The Treasury has continued to apply this general rule since 1935, except in the two cases of partnership non-capital security profits under the 1932 Act and partnership gambling gains under the 1936 Act (Pet. Br. 19-23). The latter ruling has been rejected by the Fifth Circuit, *Jennings* v. *Commissioner,* 110 F. (2d) 945, which case the Government concedes is contrary to its contention here (Gov. Br. 35n).

4. There has never been a provision in any Revenue Act denying to a partner the right to treat items of partnership income as retaining their character on his return.

5. Every provision in every Revenue Act which has dealt with the treatment of specific items of partnership income on partners' returns has directed that such items retain their character.

6. Except in the situation at bar, the courts have treated items of partnership income as retaining their character in partners' hands (Pet. Br. 34-40).

The Government also concedes that the Treasury's treatment of the foreign income of a domestic partnership (which we cite, Pet. Br. 19-23, as one of three instances in which the Treasury has filled gaps in the statute by applying the general principle) is contrary to its contention here (Gov. Br. 29). While the Government seeks to explain the other two instances on other grounds (Gov. Br. 27, 30 and *infra* pp. 4-5), it attempts to dispose of all three by arguing that the retention of their character on partners' returns does not modify the "scheme" of the Act for computing partnership net income.

The argument is that while the general principle urged by petitioner is inconsistent with what the Government con-

ceives to be the "scheme" of the Act for computing partnership net income, the three cited applications of that principle are not inconsistent with that "scheme." But if three applications of the principle that partnership items retain their character on partners' returns do not modify the scheme of the Act for computing partnership net income, there is no reason why the same treatment of a fourth item, partnership non-capital security gains, should be deemed to modify that scheme. In all four instances, the fact is that the item is taken into account in computing the partnership's net income, but its character as a particular kind of income controls in determining how that item of partnership net income shall affect the individual partner's tax.

The ruling permitting the carry-over of the 2% tax withheld at source on certain partnership bond interest is said to rest on the Treasury's desire to avoid double tax (Gov. Br. 27-8). But this is no answer. Under Section 143(d) of the 1932 Act, the credit is allowed only against the income tax "of the recipient of such income." Thus, whatever the hardship, it is impossible to arrive at the Treasury's result unless the partner's share of the partnership's bond interest income is treated as his income. Since there is no provision in the statute authorizing such treatment, the only way to reach the Government's result is by applying the general rule for which petitioner contends. G. C. M. 18120, which so holds, is all the more significant because there the partnership had no net income; nevertheless the General Counsel said that the partnership's bond interest was "included" in the individual partner's return and therefore met the requirement of Section 143(d) (Pet. Br. 21).

As to Government bond interest, the Government concedes that, in the absence of any statutory provision to that effect, the Treasury gives a partner exemption from

surtax as if he owned directly a proportionate part of the bonds owned by the partnership (Gov. Br. 30), but says that this does not modify the method of computing partnership net income.

Obviously, the Treasury Regulation modifies the method of computing partnership net income no less and no more than would the separate treatment of partnership non-capital security gains urged by petitioner. The interest on Government bonds owned by the partnership in a principal amount exceeding $5,000 is included in the partnership's gross income under Section 22(b)(4) of the 1932 Act and hence is reflected in its net income under the statutory scheme for computing the partnership's income. After that net income is determined, it is necessary under the Treasury Regulation to go behind that net income for the purpose of determining how much of that net income is interest on each partner's proportionate share of Government bonds. If it is consistent with the statutory scheme to go behind the partnership net income for the purpose of segregating Government bond interest, it is likewise consistent with that scheme to go behind the partnership net income for the purpose of segregating partnership non-capital security gains.

## II.

## The Government's attempted disproof of the general principle.

### *A. The partnership as a net income computing unit.*

The Government's major attack* on the principle we invoke is (Gov. Br. 12-17, 21, 26) that Section 183 requires

* A subsidiary attack based on an assumed need for allocation of expenses (Gov. Br. 15) is disposed of in Point III *infra*.

partnership net income to be computed as though a partnership were an entity; that the partners' distributive shares of such net income must be carried over into their returns under Section 182; and that it would violate the statutory scheme if thereafter the partners could break down the partnership income into its component parts.

But the partnership net income as computed under Section 183 is not an indestructible entity. The statute itself provides that four items which have been included in partnership net income shall be segregated therefrom for separate treatment on partners' returns: dividends (Section 184), Government bond interest for normal tax purposes (Section 184), earned income (Section 185) and capital gains (Section 186). In three other cases, where the statute is silent, the Treasury has voluntarily permitted partners to segregate items of partnership gross income from partnership net income for special treatment. These are Government bond interest for surtax purposes (Pet. Br. 19 and *supra* p. 4), partnership bond interest upon which a tax has been withheld at the source (Pet. Br. 20 and *supra* p. 4), and partnership income from foreign sources (Pet. Br. 22 and *supra* p. 3).

The Government argues that, if petitioner may segregate partnership non-capital security gains from his share of partnership net income, all items of partnership income and deductions may be so segregated on partners' returns (Gov. Br. 13). This possibility is viewed by the Government with unnecessary alarm. In effect a partner always takes over his proportionate share of each item of partnership income and deduction, despite the fact that the result may be reported on his return as a single figure. Only when a particular kind of partnership income is singled out by the statute for special treatment is segregation important.

If the Government's argument is sound, the three Treasury rulings on 2% covenant bond interest, Government bond interest for surtax purposes and foreign income of a domestic partnership (all of which are still in force) are unsound.

Nor is petitioner taking a prohibited deduction from net income instead of from gross income (Gov. Br. 12). A partner's distributive share of partnership net income appears on his return as an item of his gross income (R. 15). We seek only to segregate one of the component items of the partnership income, non-capital security gains. This is done by the 1938 Act with respect to partnership short-term (i.e., non-capital) security gains, *infra* pp. 15-18, and this was also done by the courts, Congress and the Treasury with respect to other items of partnership income under the 1932 and other Acts.

### *B. The argument that petitioner seeks an "additional deduction."*

The Government erroneously contends that petitioner is seeking a deduction in addition to those authorized by the statute (Gov. Br. 10, 28) and that, as deductions are a matter of grace, they should not be allowed unless clearly authorized by the statute (Gov. Br. 7, 36). But Section 23(r) does allow the deduction of non-capital security losses against non-capital security profits, the only question being whether petitioner's share of his partnership's non-capital security profits may be regarded as his for the purposes of the statute. The answer to this question depends on whether petitioner is correct that there is a general rule that items of partnership income retain their character on partners' returns. The Government's reference to an "additional deduction" begs the whole question in this case. The "additional deduction" argument was rejected by the Fifth Circuit in the *Jennings* case, 110 F. (2d) at 946.

### *C. The argument that under petitioner's view sections of the 1932 Act are surplusage.*

The Government urges that the specific provisions in Sections 184, 185, 186 and 188 are surplusage under the petitioner's argument (Gov. Br. 17, 26). In *Helvering* v. *Clifford,* 309 U. S. 331, the shoe was on the other foot. There the taxpayer contended that since Congress had made specific provision for taxing particular kinds of trust income to the settlor, there was no general rule that the settlor could be taxed on trust income in other situations. The Government successfully urged that the fact that Congress had defined with particularity certain instances in which the general rule applied did not contract the scope of the general rule. The surplusage argument is even weaker here than it was there since the express reference to particular types of income in the partnership sections stems directly from the Treasury's original erroneous interpretation of the 1913 Revenue Act.

### *D. The Government's authorities.*

The *Menken, Kurzman* and *Wilson* cases and O. D. 593 (Gov. Br. 22-24) held only that a partner may not deduct on his individual return items which his partnership had or could have deducted on its return. Presumably the individual partner had already benefited from these deductions in the computation of his distributive share of the partnership income or loss. These cases do not present the question whether an item of partnership income or deduction retains its character on the partners' returns. We have already dealt with the *Burns* and *Forres* cases (Pet. Br. 23n).

In *Shearer* v. *Burnet,* 285 U. S. 228 (Gov. Br. 22-23), the question was whether a partner reporting in his calendar

year return for 1924, partnership income for the fiscal year ended April 30, 1924, was entitled to reduction of 25% of the tax on any part of such partnership income. The Court pointed out that, under the statute, the 25% reduction applied only to income reported for the calendar year 1923. Presumably the partners had already received the benefit of the reduction on the partnership income for the fiscal year ended in 1923. To have accepted Shearer's contention would have contravened the express language of the statute and the congressional purpose to permit a reduction with respect to tax for a period of twelve months only. The *Colip* case involved the same point. These cases neither presented nor discussed the question here.

### *E. The Government's discussion of petitioner's authorities.*

Petitioner cited three cases holding that items of partnership income retain their character on partners' returns in the absence of statutory provision. The Government concedes that the *Jennings* and *Craik* cases support petitioner's view (Gov. Br. 29, 35n), but erroneously says the holding in the *Craik* case was limited to the narrow issue before the court. On the contrary, the Court of Claims adopted the general rule urged by petitioner, and even went out of its way to state that an individual should have every deduction from partnership income which he might take from his individual income (Pet. Br. 37-40). The rule thus stated requires the allowance of the offset sought by petitioner.

The Government attempts three explanations of the *Coulby* case (Gov. Br. 33-34):

(1) It is said to rest upon the specific provisions of the 1913 Act, but no provision of the 1913 Act is cited.

(2) It is said that that Act required no partnership return. But the Commissioner was authorized by Section D

to require a return. In any event, as the partnership return is merely an information return, it is immaterial whether one was required from all partnerships, since the 1913 Act (like the later statutes) required partners to report their distributive shares of partnership net income.

(3) It is said that the *Coulby* decision was in accordance with the provision in the 1916 Act specifically allowing a deduction by individual partners, and that that provision was a legislative recognition of the intent of the 1913 Act. That is precisely our contention as to the effect of the 1938 Act in this case (Pet. Br. 33-34).

All three attempts to explain the *Coulby* case run counter to the Treasury's acceptance of that decision for sixteen years as controlling under later Acts, including the 1928 Act, the partnership provisions of which were identical with the 1932 Act (G. C. M. 13771, XIII-2 C. B. 229 (1934), Pet. Br. 22).

## III.

### The Government's suggestion concerning allocation of expenses.

The Government suggests that petitioner should have made an allocation of partnership expenses to the firm's non-capital security gains* (Gov. Br. 15). But the Board found (R. 21) that the partnership had a profit from non-capital security transactions of $142,802.29, that its net income was $109,651.06, and that petitioner's distributive share was $36,000 of the first $94,000 and 45% of the excess

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* This is obviously an afterthought. The point was not presented by the Commissioner's deficiency notice (R. 7-10), nor raised by the Government at any time before it filed its brief on the merits in this Court.

(about $44,000; Gov. Br. 3). On these findings it is clear that all of petitioner's $44,000 share of the partnership net profit may be attributed for the purposes of this case to the firm's non-capital security transactions.

The Government's argument is, in effect, that under the second of two alternative methods of computation, it is necessary to apportion the partnership's business expense deductions between the non-capital gains and other income of the partnership. But it is the first of the alternative methods, requiring no such allocation, which is the established practice. In most, if not all, situations where the principle of treating an item of partnership income as retaining its character on partnership returns is applied, the question is presented whether to allocate any part of the partnership's deductions against such item. Yet such an allocation has never been made. Wherever the statute has made provision for special treatment of items of partnership income on partners' returns, credit has been given to the partners for their *full* proportionate shares of such items without regard to possible expenses and other deductions of the partnership.* This is also the practice which has been followed by the Treasury for 20 years and which was adopted in the *Coulby, Craik* and *Jennings* cases. As the Fifth Circuit said in the *Jennings* case (110 F. (2d) at 946):

> "The partnership return is for information, and to secure uniformity and save repetition in the individual

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* Except that since 1934 the credit for dividends and Government bond interest (for normal tax purposes) has been limited to the amount of the partnership's net income (Sec. 184 of the 1934, 1936 and 1938 Acts), thus adopting the rule early applied by the Treasury. A. R. M. 13, 2 C. B. 168 (1920).

returns. It ascertains each partner's gain and apportions it to him to be taxed, whether distributed or not. It does not transform his share in the gain."

Under the 1913 Act, which contained no provision for separate treatment of items of partnership income on partners' returns, the Treasury ruled that where a partnership had dividend income and operating losses, the full amount of the net income should be treated as dividend income. A. R. M. 13, 2 C. B. 168 (1920). This ruling is directly in point here, where the operations of the partnership apart from its non-capital security gains resulted in a loss (R. 21). Under this ruling, all of petitioner's $44,000 share of his partnership's net income may be treated as non-capital security gain for the purposes of this case.

In 1937 this rule was extended to the extreme situation where a partnership had a net loss, the Treasury still holding that the item to be specially treated carried over into the partners' returns. G. C. M. 18120 (Pet. Br. 21 and *supra* p. 4).

The correct approach is that which the Treasury has always taken with respect to Government bond interest for surtax purposes (Pet. Br. 19 and *supra* pp. 4-5). The Treasury gives each partner exemption as though he owned directly his proportionate share of the Government bonds owned by the partnership. The Treasury has never suggested that the interest on such proportionate share of Government bonds should be reduced by an allocation thereto of deductions of the partnership, although ordinarily Government bond interest of the partnership would be merged on its books with other income and offset by deductions of the partnership.

No other approach would satisfy the rule that items of partnership income retain their character on partners' returns, since only in this way does the partner obtain the full benefit of the special treatment provided for the particular kind of income in question.

## IV.

## The Government's failure to meet petitioner's challenge as to the meaning of Section 23(r) as supported by later enactments.

We have challenged the Government to point to anything in Section 23(r), or in the 1932 Act, or in the Committee Reports, showing that Congress intended to prevent the offset of individual non-capital security losses against a partner's share of partnership non-capital security gains (Pet. Br. 25). This challenge stands unanswered, as of necessity it must.

### *A. The Government's argument based on the converse situation.*

Instead of meeting the challenge, the Government has sought indirectly to bolster its interpretation of Section 23(r) as denying the offset in question by reference to the converse situation, i.e. the setoff by partners of their shares of excess non-capital security losses of the partnership against their individual non-capital security gains. The Government assumes that such setoff is not permissible, citing *Woolford Realty Co.* v. *Rose,* 286 U. S. 319* (Br.

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* *Ardenghi* v. *Helvering,* 100 F. (2d) 406, cited twice (Gov. Br. 15n, 25) has nothing to do with this case.

15n, 25) and Section 187 of the 1932 Act (Br. 25n), and urging that losses disallowed to the partnership are in no event available to the partners. This argument is completely without merit:

1. The *Woolford Realty* case held that, for purposes of the net loss carryover from a preceding year, in the case of corporations filing consolidated returns, the limitation of the carryover to the amount of the "net income" in the succeeding year precluded a carryover by an affiliate having a net loss in the succeeding year. This was in accord with the intent of Congress and the uniform administrative interpretation.

But for 20 years the Treasury has held that "net income" in Section 182 of the 1932 Act and similar sections of other Acts includes "net loss" and that a partner may deduct his share of the partnership current year "net loss" on his return despite the absence of any provision to that effect in the statute. Art. 30 (par. 213), Regs. 33 (1916 Act); Art. 332, Regs. 62 (1921 Act); Art. 336 of Regs. 65 (1924 Act) and 69 (1926 Act); Art. 902 of Regs. 74 (1928 Act) and 77 (1932 Act); Art. 182-1(b) of Regs. 86 (1934 Act) and 94 (1936 Act). See also Art. 183-1 of Regs. 86 and 94, apparently nullifying in part the Congressional purpose under the 1934 and 1936 Acts to deprive partners of the benefit of partnership capital losses.

2. Section 187, dealing with net losses carried over from prior years, has no bearing on the question whether a partner may deduct his share of the partnership's net loss for the current year or whether a partner may take his share of current year partnership losses disallowed to the partnership. Both points are covered by Treasury Regulations expressly applicable to partnerships. Current year net losses

are covered by the Regulations cited in the preceding paragraph. The only current year deduction disallowed to partnerships prior to 1933 was the charitable contribution deduction (Sec. 183, 1932 Act and its predecessors commencing with Sec. 218, 1918 Act*). Under all these Acts the Treasury permitted partners to deduct their shares of the partnership's contributions.**

Art. 261(e) of Regs. 77 (1932 Act) provided:

> His proportionate share of contributions made by a partnership may be claimed as a deduction in the personal return of a partner to an amount which, when added to the amount of contributions made by the partner individually and claimed as a deduction, is not in excess of 15 per cent of the partner's net income computed without the benefit of the deduction for contributions.

By analogy to this treatment of charitable contributions, excess non-capital security losses disallowed to the partnership by Section 23(r) were available to partners under the 1932 Act. So the Senate Finance Committee said in amending the law in 1933, and its statement is supported by Section 23(r) (2) of the 1932 Act (*infra* p. 19).

### *B. The Government's attack on the force of the 1938 Act and Section 218(d).*

In the 1938 Act, the first general Revenue Act following the *Johnston* case, Congress expressly provided that partnership short-term security profits (the equivalent of partner-

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* Sec. 218, 1921, 1924 and 1926 Acts; Sec. 183, 1928 Act.

** Art. 251 of Regs. 45 (1918 Act), 62 (1921 Act), 65 (1924 Act) and 69 (1926 Act); Art. 261 (1928 Act).

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ship non-capital security profits under the 1932 Act) retain their character on partners' returns; thus prospectively voiding the Treasury's ruling in this case. The draftsmen regarded the new section as a logical corollary of the proposition that only partners as individuals, not the partnership as an entity, are subject to tax (Pet. Br. 32-34). The Government makes three attempts to avoid the impact of the 1938 Act upon this case:

(1) It erroneously says that the Committee Report indicates that the new provision represented a change in the law (Gov. Br. 18). The Committee expressly said that it was changing the treatment of partnership security *losses* (Pet. Br. 32-33). It did not say that it was changing the treatment of partnership security *gains*. The specific reference to *gains* was explained as a "logical corollary" of the principle that partnerships are not taxable entities.

(2) The Government erroneously states that the Committee Report supports its contention here (Gov. Br. 20-21). The portion quoted by the Government precedes that quoted by petitioner (Br. 32-33) and is in no way inconsistent with it. The Government's quotation merely states the general rules that the income of a partnership is to be computed in the same manner as that of an individual and that the tax is paid by the partner on his distributive share of the partnership net income. Petitioner's quotation indicates that, despite these general rules and consistently therewith, items of partnership income retain their character on partners' returns. There is nothing in the portion quoted by the Government to indicate Congress' views with respect to the treatment of non-capital partnership security gains under earlier Acts, whereas the portion quoted by petitioner clearly indicates that Congress believed that such gains retained their character on partners' returns under the earlier Acts.

(3) The Government stresses the language of Section 183 of the 1938 Act providing that partnership short-term gains and losses shall be excluded from the computation of partnership net income (Br. 18, 21). There is no magic in the use of the word "exclude." The treatment accorded by the 1938 Act to partnership short-term gains and losses is in substance the same treatment expressly accorded by the earlier Acts to dividends, Government bond interest (for normal tax purposes), earned income and capital gains, and voluntarily accorded by the Treasury to Government bond interest (for surtax purposes), bond interest upon which tax was withheld at source, and income from foreign sources. Under the earlier Acts and Treasury rulings, each of these items was first taken into account in computing partnership net income, and was then segregated for special treatment on the partners' returns.* The effect of such segregation was to exclude these seven items from the partnership net income as shown on the individual partners' returns. Section 183 of the 1938 Act merely describes in express terms the practice followed for 20 years without such express language. Obviously, it is immaterial whether such segregation is made before (as under the 1938 Act) or after (as under

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*This appears graphically from instruction 5 attached to the 1932 individual income tax return (Form 1040), which said: "Enter as Item 5 your share (whether received or not) of the profits of a partnership, * * * except that the share of (a) capital net gain or loss computed as provided in Instruction 8a shall be reported in Schedule D, (b) taxable interest on obligations of the United States shall be included in Schedule E, and (c) profits which consisted of dividends on stock of domestic corporations shall be included in Item 10 ((a) and/or (b)) on the return. Include in Items 39 and 40, respectively, credits claimed for [partnership] income tax paid at source, and [partnership] foreign income taxes." In addition to the items mentioned in the instructions, income from foreign sources may also be segregated (G. C. M. 13771, XIII-2 C. B. 229).

the earlier Acts and Treasury rulings), the partnership net income is computed.

The Government also makes four attempts to show that Section 218(d) does not support petitioner's contention:

(1) The Government suggests that the Finance Committee Report cited by petitioner (Br. 27-8) may have referred to net losses carried over from prior years (Gov. Br. 30-31). But such net losses were covered by Section 187, which was repealed by Section 218(a) of the National Industrial Recovery Act and explained by a separate portion of the Committee Report (73rd Cong., 1st Sess., S. Rept. 114, p. 7).*

(2) Alternatively, the Government suggests that the Committee Report referred to capital losses and not to non-capital losses (Gov. Br. 31-32). But capital losses were expressly covered by Section 186 and neither the draft of Section 218(d) nor its final form made any reference to Section 186 or to capital losses. The reference in the draft to Section 23(t) shows that the Committee was thinking only of non-capital losses, since Section 23(t) refers to Section 23(r). If the Government were right that the Committee's reference to security losses was to capital losses, then we have the amazing situation of an amendment proposed for the purpose of changing Section 186 (which it never mentioned) and finally enacted for the sole purpose

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* In a footnote (Gov. Br. 31n) the Government suggests that, despite the repeal of Section 187, Section 218(d) was necessary to prevent the carryover to 1933 of a 1931 net loss under the 1928 Act. This is flatly wrong. Section 1 of the 1932 Act makes that Act applicable to 1932 and succeeding years, and preserves earlier Acts only for earlier years. Section 187 of the 1932 Act (Pet. Br. 56) referred back to Section 117, and under Section 117(d), a 1931 loss could not be carried beyond 1932. Compare *Albert K. Miller*, 40 B. T. A. 514.

of restating what the Government says was the prior law. And this in an emergency measure!

(3) The Government says that Section 218(d) of the National Industrial Recovery Act is declaratory of the 1932 law for the reason that excess partnership non-capital losses were not available to partners in 1932 (Gov. Br. 32). We have already demonstrated (*supra* pp. 13-15) that, by analogy to the Treasury's treatment of charitable contributions, excess partnership non-capital security losses were available to partners. This is confirmed by Section 23(r)(2) *infra* this page.

(4) The Government also refers to the carry-over under Section 23(r)(2) to the succeeding year of excess non-capital losses disallowed by Section 23(r)(1) (Gov. Br. 33). But obviously this carry-over provision has no reference to partnerships. The carry-over is permitted "to an amount not in excess of *the taxpayer's* net income for the taxable year". (Italics supplied.) As the Government has repeatedly pointed out in its brief, a partnership is not a taxpayer; and since the provision is limited by its language only to taxpayers, it is clear that it did not affect partnerships. Section 23(r)(2) meant only that excess non-capital security losses of partnerships, available to partners under the same theory as charitable contributions disallowed by Section 183, were to be carried over to the succeeding year only to the extent not applied by the individual partners in the preceding year (limited to their net incomes for that year).

So far from aiding the Government's argument that Section 218(d) was declaratory, the language of Section 23(r)(2) conclusively demonstrates that, in the absence of Section 218(d), excess partnership non-capital security

losses were deductible by the partners, just as the Committee had said (Pet. Br. 27-8).

## V.

### The constitutionality of Section 23(r).

The Government's constitutional argument (Br. 37-8) rests on the false premise that, since deductions are matters of legislative grace, petitioner, who has already received the benefit of a deduction specifically allowed, cannot protest that Congress should have been "more generous."

The premise is false for the reason that Congress, in exercising its legislative grace, may not discriminate arbitrarily. *Brushaber* v. *Union Pacific R. R.*, 240 U. S. 1, 24-5; *Denman* v. *Slayton*, 282 U. S. 514, 520. Petitioner has been required to pay a tax on his share of his partnership's non-capital security gains although he has sustained non-capital security losses and although both gains and losses were the fruits of his single security trading business. Hence, he has not received the same benefit from a deduction specifically allowed by Congress as have other taxpayers whose business was speculation in assets other than corporate securities, or who, though speculating in corporate securities, conducted their business as individuals.

This double barreled discrimination is not based on policy considerations or on any reasoned classification. There is nothing in the Committee Reports cited by the Government to justify either discrimination; the only distinction sought to be justified by Congress was that between speculators and investors.

The Government ignores the argument that petitioner is discriminated against because he is a member of a part-

nership, unless the statement that "all taxpayers similarly situated are treated alike" by the statute is intended to be an answer; but the only force of this statement is to point out that there may be other members of partnerships in petitioner's situation. It is no justification of the statute to point out that one group has been unfairly treated without reason grounded on policy considerations or purposeful classification.

None of the Government's cases supports a tax which is arbitrary not only in its classification, but also in singling out profitable transactions for separate taxation despite losses on similar transactions sustained in the same business.

## CONCLUSION.

**For the reasons set forth above and in petitioner's main brief, the judgment should be reversed.**

Respectfully submitted,

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October, 1940.